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DIRECTORTATE OF INTELLIGENCE

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Japan: Nakasone Turning to Economic Issues

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Summary

As the November Liberal Democratic Party (LDP) presidential election approaches, Prime Minister Nakasone will increasingly be forced to deal with economic issues--his weakest suit according to most analysts. Overall, the economic news in Japan--especially the recovery of growth--looks good. But the Diet session that will extend into the summer must tackle legislation on items such as the costs of health care that can cause difficulties for the LDP. Nakasone has little flexibility for dealing with these problems or a slowdown in domestic growth because of the persistent central government deficit. 25X1

Some Good Economic News

In some respects, Prime Minister Nakasone can look forward to good economic news this year. Mainly on the strength of domestic demand, GNP growth is picking up and should top the 4

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percent mark. The official growth target for the fiscal year, which began 1 April, was set at 4.1 percent, and we agree with most forecasters that the Japanese will reach this goal[1]. Indeed, most major private forecasters are more optimistic than the government. [redacted] 25X1

Our own estimate, based in part on econometric model results, shows private demand--especially private investment--on the rise, while government spending continues to increase more slowly than GNP.

-- We expect housing investment to be up in 1984 after several years of decline.

-- Plant and equipment investment has also begun to pick up as the recovery has pushed production levels closer to capacity and profitability has improved. [redacted] 25X1

The weakest area of the domestic economy is consumer demand, which accounts for nearly half of GNP. Continued modest gains in real wages and salaries will keep the rate of growth of private consumption expenditures slow. [redacted] 25X1

Foreign Demand Losing Its Kick

In contrast to last year, when the external sector accounted for nearly half of GNP growth, external trade will give only a small boost to growth in 1984. The Economic Planning Agency (EPA) forecasts that external demand will make up only 0.5 percentage points of 1984's 4.1 percent projected growth, with domestic demand accounting for the remaining 3.6 percentage points. [redacted] 25X1

We agree with the EPA assessment.

-- There is little prospect that exports to LDCs will pick up rapidly. Many of the countries that have been Japan's growth markets in Latin America and the Middle East are faced with slower growth and, in many cases, need to conserve foreign exchange for debt repayment.

-- The delayed impact of yen appreciation with respect to the European currencies means exports to industrial

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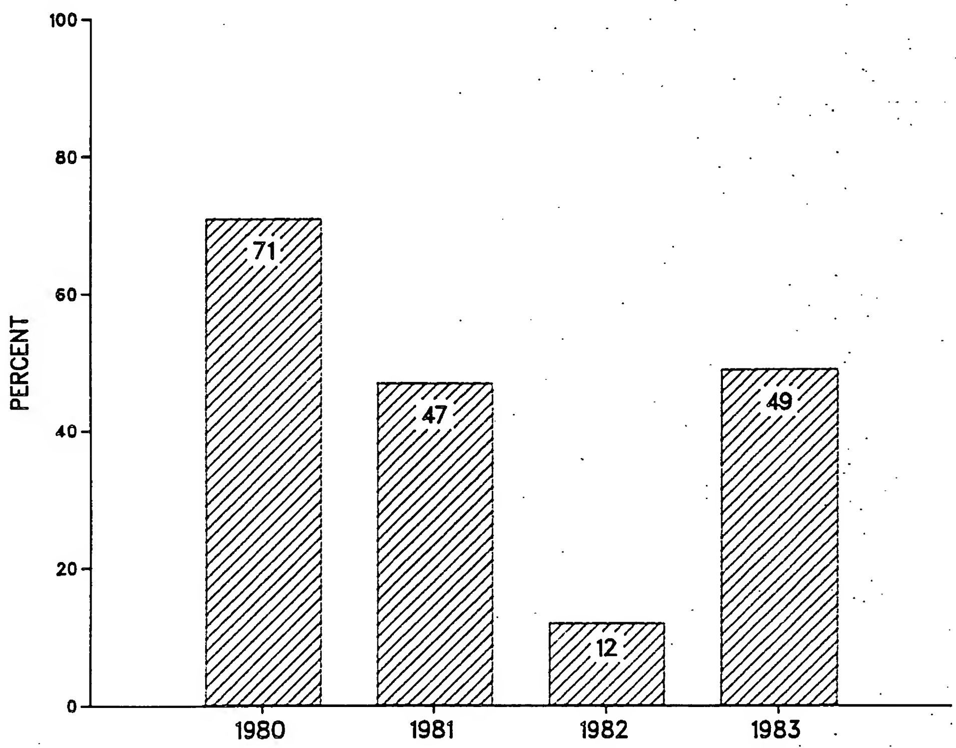
1 All annual figures in this memorandum refer to the Japanese fiscal year. [redacted] 25X1

JAPAN: FOREIGN DEMAND'S CONTRIBUTION TO GNP GROWTH



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countries are also likely to show less strength. At the same time, the stronger yen and continued economic growth will eventually boost imports, reducing net foreign demand even more. [redacted] 25X1

Nagging Current Account Surpluses

Although the growth of net exports--the surplus of real exports over real imports in the GNP accounts--will be low, the gap between exports and imports in nominal dollar terms continues to rise, although at a slower pace. We expect the current account surplus to reach $25-30 billion in JFY 1984[2] compared with $24 billion last year (see Figure 2). The Economic Planning Agency has officially forecast a surplus roughly the size of 1983's--$23 billion--but the press has speculated that the EPA may boost its forecast to $30 billion. Most other major forecasters expect it to be in the $20-30 billion range. A few, including the prestigious Japan Economic Research Center and the Mitsubishi Research Institute, expect it to top $35 billion. These overall estimates include an increase of at least $5 billion in the trade surplus with the United States from last year's level of about $20 billion. [redacted] 25X1

For 1984, stronger dollar export prices will account for much of the increase in the current account surplus. Export volume--measured by the value of exports in constant 1975 dollars--is only expected to increase 2 percent, but higher dollar prices for Japan's export goods will push the value of exports in current dollars up by over 10 percent. Import volume, buoyed by the domestic recovery, should be up by about 8 percent. Assuming world oil prices and costs for other important raw materials remain relatively stable, however, the dollar value of imports will about match the 10 percentage point rise in the value of exports. [redacted] 25X1

Economic Battles Loom

Despite the relatively good news on economic growth, the Diet session this summer will focus on some tough economic issues that must be balanced against what is seen as an excessive central government deficit. Fiscal policy is constrained by the persistent deficit, which amounts to about 25 percent of central government expenditures. [redacted] 25X1

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2 See appendix for key assumptions and alternative scenarios.

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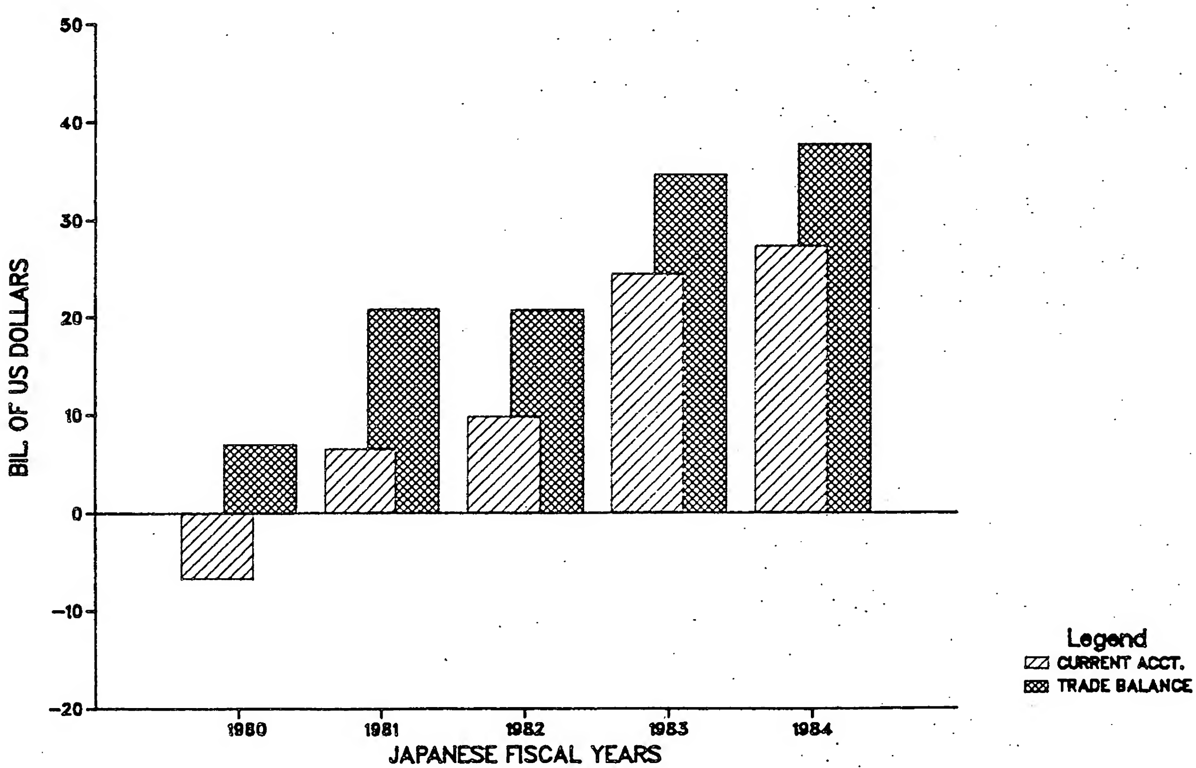
JAPANESE CURRENT AND MERCHANDISE TRADE ACCOUNTS



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Even with growth up, Nakasone is being criticized for not doing enough to push the economy. Within his own party, Director General Komoto of the Economic Planning Agency--a potential rival for the presidency of the LDP in elections this fall--has called for more expansionary policies, including a further tax cut aimed at business. According to a press report, his goal is a 5 to 6 percent growth rate. In addition, the Ministry of International Trade and Industry (MITI) favors a higher growth target. [redacted] 25X1

The opposition parties--especially the Socialists and Komeito--have criticized Nakasone for not aiming for more rapid growth, and they were particularly dissatisfied with the FY 1984 budget. This year's budget offers little stimulus, and in fact shows the slowest growth in 30 years. Expenditures, at 50.6 trillion yen, are only 0.5 percent over the 1983 level, a decline of 2 percent in real terms. [redacted] 25X1

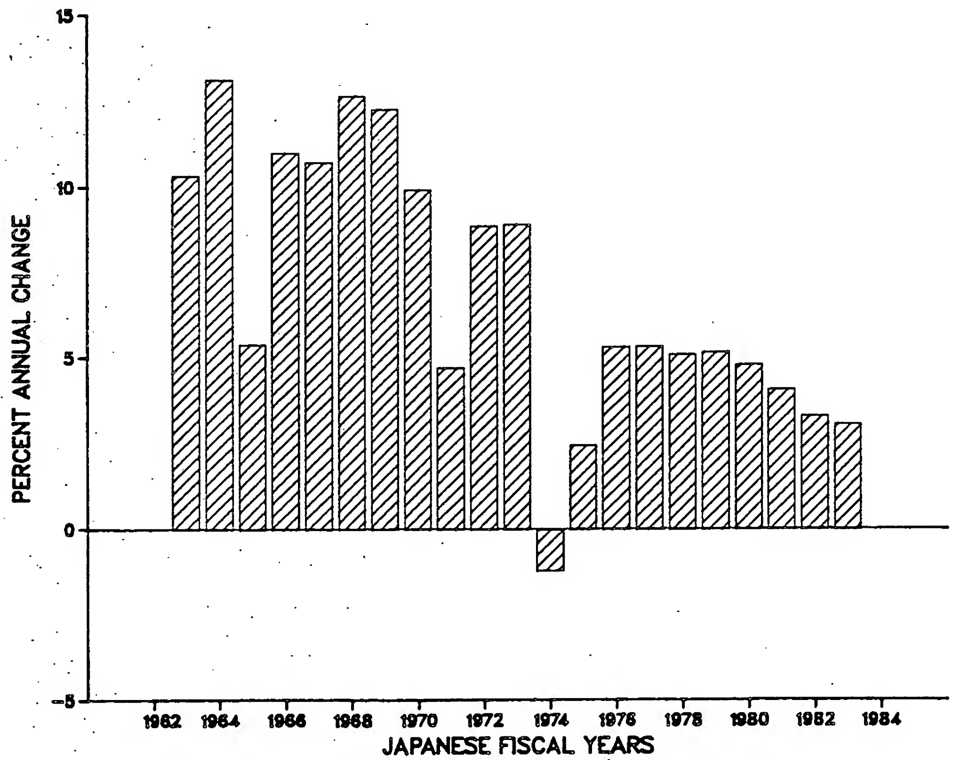
At this point, it appears that the Diet debate will revolve around deficit-cutting measures and funding of specific programs. The sharpest arguments will probably be over a bill to reform the national health program by instituting participant fees in the health insurance system. [redacted] 25X1 [redacted] the bill is viewed as one of the keys to rehabilitating 25X1 the government's fiscal and budgetary program and will be the major test this summer of Nakasone's ability to manage the Diet. The Finance Ministry drafted the current budget on the assumption that this bill, which will cut government costs by $1.8 billion when implemented, would be passed by 1 July. If it is delayed, the budget will have to be extensively revised. The opposition parties and powerful medical associations oppose the bill and have already blocked an LDP attempt to force quick action on the new legislation. [redacted] 25X1

If growth should slow later this year, Nakasone would be faced with additional problems. Because of the deficit, Nakasone would find it nearly impossible to stimulate the economy using fiscal policy measures. To increase GNP by 1 percent, for example, would require pump-priming expenditures of around $6 billion--a far larger amount than the increase in the entire government budget for 1984. [redacted] 25X1

A downturn in growth later this year could well raise the question of Japan's long-term growth potential and the need for fundamental change--issues that can only provoke contentious debate. Even with strong export performance, Japanese growth rates have been falling since the mid-1970s. From a level of about 10 percent per year in the 1960s and early 1970s, they have declined over the past decade--mainly because of the two oil shocks and changes in the structure of Japan's economy--to about

3 percent. (see Figure 3). Tokyo's fiscal policy options for boosting growth will probably remain constrained by the central government's persistent budget deficit. Deficit-financing bonds, which were initially intended to be a short-term expedient, are beginning to mature this year, making government financing increasingly difficult. The pressure to cut spending or raise taxes will probably increase during this decade as the earlier bonds begin to come due and financing costs rise.

JAPANESE REAL GNP GROWTH RATES, 1963–1983



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Appendix

Alternative Scenarios

Several key assumptions about the yen's value and external events underlie our trade forecast. Sudden changes in the cost of oil or the value of the yen could sharply alter the outlook for trade this year, as they have in the past. 25X1

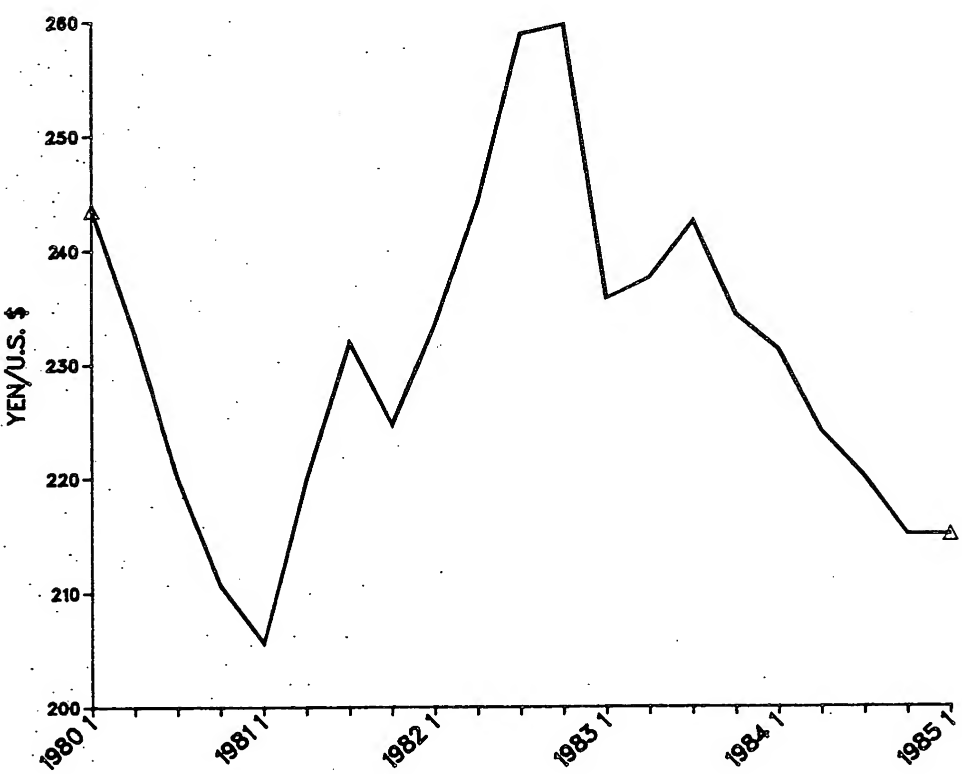
Yen Appreciation: We assume the yen will appreciate to 215 yen per dollar by year's end, but it could appreciate against the dollar more rapidly (see Figure 4). In the past, changes in the yen's value by 40 yen per dollar or more in one year have been common. Major Japanese forecasters, in their trade projections published earlier this year, were calling for an exchange rate in the 220-230 yen per dollar range. The EPA used the then-current rate of 234 yen per dollar, which is already out of date. 25X1

In the short run, more rapid appreciation would probably increase Japan's surplus, because trade volume would not adjust immediately. If the yen appreciated to 190 yen per dollar, we estimate the current account surplus would reach $33 billion; if the yen remains at its current level of about 225 yen per dollar, the current account surplus would be $24 billion, according to our model. 25X1

Oil Prices: Japan is vulnerable to drastic oil price changes because its economy depends on imported oil for over 60 percent of its total energy needs. Crude oil imports in calendar year 1983 amounted to $40 billion. Both the 1973 and 1979 OPEC oil price runups turned large trade surpluses into deficits. We do not expect much change in oil prices this year, but if they occur, they would substantially alter Japan's trade outlook. We estimate that a $5 per barrel increase in oil prices would reduce the current account surplus by $12 billion; a $5 decline would increase the surplus to $39 billion. 25X1

World Import Volume and Prices: We expect total world import volume to grow by about 6.5 percent in real terms. A percentage point change in the growth rate of world trade up or down would change the current account surplus by $3 - 4 billion (see tabulation).

YEN/DOLLAR EXCHANGE RATE, 1980–84



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Japan's Current Account Surplus Under Differing Trade Assumptions

Percentage Change in Total World Import Volume (less Japan)	5.5%	6.5%	7.5%
Estimated Current Account Surplus (Billion US Dollars)	$24	$27	$30

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An increase in raw material and foodstuffs import prices would also reduce the surplus. A 5 percent average increase in these prices above our baseline increase of 2 percent would raise Japan's import bill by $1.3 billion, cutting the surplus by the same amount. 25X1

<u>Protectionism Abroad</u>: Protectionist measures by Japan's major trading partners could also reduce the surplus. Restrictions are already in place on a large proportion of Japanese exports, however, and in many cases exporters have been able to raise unit prices on restricted goods, maintaining the total dollar volume of sales. 25X1

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